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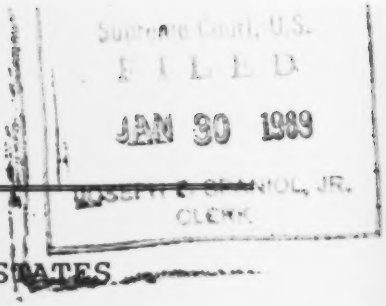

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1988

AARON ARONOV, PETITIONER,

v.

SECRETARY OF REVENUE,
DEPARTMENT OF REVENUE,
STATE OF NORTH CAROLINA,
RESPONDENT.

PETITION FOR A WRIT OF CERTORARI TO THE SUPREME COURT OF NORTH CAROLINA

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93 pp

QUESTION PRESENTED

Whether the Secretary of Revenue's construction of North Carolina General Statute Section 105-147(9)d2, requiring a nonresident individual taxpayer to reduce his distributive share of partnership net operating losses each year by his income derived from outside North Carolina and beyond its taxing power, taxes indirectly income derived from outside North Carolina in violation of the due process clause of the Fourteenth Amendment to the Constitution of the United States and/or the commerce clause of the Constitution of the United States.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	3
Constitutional Provisions Involved	4
Statutes and Regulations Involved	5
Statement	6
1. Introduction	6
2. Administrative Proceedings	14
3. Judicial Proceedings	20
Reasons for granting the Writ	34
1. The decision below conflicts with this Court's Precedent Under the due process clause of the Fourteenth Amendment	35
A. Frick v. Pennsylvania	38
B. Maxwell v. Bugbee	42
C. There is no connection between Petitioner's out of state income and his in state limited partnership interest . .	46

2. The decision below conflicts with this Court's precedents under the Commerce Clause . 50

Conclusion 58

Appendix A (Supreme Court Opinion) 1a

Appendix B (Supreme Court Order denying rehearing) 40a

Appendix C (Court of Appeals Opinion) 41a

Appendix D (Superior Court Order) 59a

Appendix E (Tax Review Board Administrative Decision No. 212) 64a

Appendix F (Final Decision of Assistant Secretary of Revenue) . . . 68a

TABLE OF AUTHORITIES

CASES:	Page
American Trucking Association, Inc. v. Scheiner, 483 U.S.____ 97 L.Ed.2d 226 (1987)	56-57
Armco, Inc. v. Hardesty, 467 U.S. 638, 81 L.Ed.2d 540 (1984)	57
ASARCO, Inc. v. Idaho State Tax Comm., 458 U.S. 307, 73 L.Ed.2d 787 (1982)	47,49-50
Commissioner of Revenue v. Tufts, 461 U.S. 300, 75 L.Ed.2d 86, reh. denied, 463 U.S. 1215, 77 L.Ed2d 1401 (1983)	17
Commonwealth Edison v. Montana, 453 U.S. 609, 69 L.Ed.2d 884 (1981)	52-53
Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 51 L.Ed.2d 326 (1977)	52-53
Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 77 L.Ed.2d 545 (1983) . .	57
Frick v. Pennsylvania, 268 U.S. 473, 69 L.Ed 1058 (1925) . . .	24-26, 29-42, 46
Maxwell v. Bugbee, 250 U.S. 525, 63 L.Ed. 1124 (1919)	24-25, 29-33, 35-36, 38-46

Miller Bros. v. Maryland, 347 U.S. 340, 98 L.Ed.744 (1954). . . . 47

State v. Ballance, 229 N.C. 764, 51 S.E.2d 731 (1949) 23

State v. Collins, 169 N.C. 323, 84 S.E. 1049 (1915) 23

Tufts v. Commissioner of Revenue, 651 F.2d 1058 (5th Cir. 1981). 16-17

Tulsa Professional Collection Services, Inc. v. Pope, 485 U.S. ____ 99 L.Ed.2d 565 (1988) 37

Tyler Pipe Industries, Inc., v. Washington State Department of Revenue, 483 U.S. ____, 97 L.Ed.2d 56
199 (1987)

Westinghouse Electric Corporation v. Tully, 466 U.S. 388, 80 L.Ed.2d 300 (1984) 54-56

CONSTITUTIONAL PROVISIONS:

U.S. Const. Art I, §8, cl.3. . . 4, 21-22, 27-29, 35, 51-53

U.S. Const. Amend. XIV, §1. . . 4, 21-24, 27, 29, 35-37, 39-40, 49

N.C. Const. Art. I, §19 . . . . 4, 21-24, 27, 29

STATUTES AND REGULATIONS:

N.C.G.S. §105-147(9)d2 . . . . 5, 13, 21-24, 27, 29, 36-37, 42, 45, 50-51, 53

17 N.C.A.C. Sub. 6B, Rule .2604 (1984). 5, 21-22

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SECRETARY OF REVENUE,
DEPARTMENT OF REVENUE,
STATE OF NORTH CAROLINA,
RESPONDENT.

PETITION FOR A WRIT OF
CERTIORARI TO THE
SUPREME COURT OF NORTH CAROLINA

The petitioner, Aaron Aronov, hereby petitions the Supreme Court for a writ of certiorari to review the judgment of the Supreme Court of North Carolina.

OPINIONS BELOW

The opinion of the Supreme Court of North Carolina, dated September 7, 1988,

is reported at _____, N.C. _____, 371 S.E.2d 468, and is reprinted in Appendix A hereto, infra, p. 1a.-39a.

The opinion of the Court of Appeals of North Carolina dated May 19, 1987, is reported at 85 N.C. App. 677, 355 S.E.2d 854, and is reprinted in Appendix C hereto, infra, p. 41a-58a.

The order of the General Court of Justice, Superior Court Division, Wake County, North Carolina entered on May 29, 1986, has not been officially reported. That order is set out in Appendix D hereto, infra, p. 59a-63a.

The Administrative Decision No. 212 of the Tax Review Board of North Carolina entered on January 31, 1985, has not been officially reported. That decision is set out in Appendix E hereto, infra, p. 64a.-67a.

The Final Decision of the Assistant

Secretary of Revenue of North Carolina entered on June 21, 1984, has not been officially reported. That decision is set out in Appendix F hereto, infra, p. 68a.-86a.

JURISDICTION

The opinion of the Supreme Court of North Carolina (infra, p. 1a-39a) was entered September 7, 1988. The order of the Supreme Court of North Carolina denying a petition for rehearing was entered on November 3, 1988, and is reported at _____ N.C. _____, 373 S.E.2d 860, and is reprinted in Appendix B hereto, infra, p. 40a. This petition for a writ of certiorari is filed within 90 days of the rehearing denial. The jurisdiction of this Court is invoked under 28 U.S.C. §1257(a) (formerly 28 U.S.C. §1257(3)).

CONSTITUTIONAL PROVISIONS INVOLVED

1. The Due Process Clause of the Fourteenth Amendment to the Constitution of the United States (Amendment XIV, §1) reads in its entirety as follows:

> "[N]or shall any State deprive any person of life, liberty, or property, without due process of law;"

2. The Commerce Clause of the Constitution of the United States (Article I, Section 8, Cl. 3) reads in its entirety as follows:

> "The Congress shall have the Power...To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;"

3. The Law of the Land Clause of the Constitution of the State of North Carolina (Article I, Section 19) reads in its entirety as follows:

> "No personal shall be taken, imprisoned, or disseized of his freehold, liberties, or privileges, or outlawed, or exiled, or in any manner

> deprived of his life, liberty, or property, but by the law of the land."

STATUTE AND REGULATION INVOLVED

1. North Carolina General Statute Section 105-147(9)d2 (1985) reads in its entirety as follows:

> "2. The net economic loss for any year shall mean the amount by which allowable deductions for the year other than personal exemptions, nonbusiness deductions and prior year losses shall exceed income from all sources in the year including any income not taxable under this Division."

2. Title 17, North Carolina Administrative Code, Subchapter 6B, Rule .2604 (April 6, 1984), reads in part as follows:

> "If a nonresident or part-year resident with income reportable to North Carolina and also with income not taxable to North Carolina has a loss on the North Carolina income, he must reduce the loss by the income not taxable to North Carolina under this division before he may carry the loss over to the ensuing year."

STATEMENT

1. INTRODUCTION.

There is but one question in this case. Does a state tax indirectly the income of a nonresident individual taxpayer earned outside the state and beyond its taxing power by the device or scheme of using such income to reduce a loss deduction otherwise allowable to the taxpayer under the state's income tax statutes? Petitioner respectfully submits that the answer to this question is yes.

The relevant facts are not in dispute. Petitioner, Aaron Aronov, during the years 1975 through 1978 was a nonresident of North Carolina, domiciled and residing in Montgomery, Alabama. (App., infra, p.2a and 78a) During this period, Petitioner was doing business in North Carolina as a limited partner in

Freedom Drive Mall, Ltd. (Freedom Mall), a limited partnership which operated a shopping center in Charlotte, North Carolina. As one of the limited partners in Freedom Mall, Petitioner was merely an investor in a limited partnership holding a leasehold interest in North Carolina property. (App., infra, p. 2a-3a, 78a)

Freedom Mall held a leasehold interest in real property used in its shopping center business during the period 1975 through 1978. The property was acquired subject to indebtedness. The indebtedness in respect of the real property created no personal liability of the partnership or upon the partners; the debt involved was nonrecourse debt, insofar as the taxpayer and the partnership were involved. (App., infra, p. 79a)

The partnership venture was

unsuccessful. For each of the taxable years 1975, 1976 and 1977, the partnership realized net operating losses of $195,438.62, $309,789.78 and $450,279.10, respectively. Petitioner's distributive share of the net operating losses of the partnership for the taxable years 1975, 1976 and 1977 was $52,768.43, $83,643.24, and $121,575.36, respectively, for a total distributive share of net operating losses for those years of $257,987.03. (App., infra, p. 3a, 7a-79a)

An operating loss from regular operations was also sustained in the 1978 year in the amount of $28,394.11. (App., infra, p. 80a)

Throughout the period involved, the losses were generated largely by depreciation and interest deductions on the subject partnership property. The

recapture of those same depreciation deductions in 1978 substantially produced the technical 1978 gain.

In the year 1978, due to the economic unfeasibility of the partnership and its disastrous financial operations, the lender sought to reacquire the property. Thus, on March 1, 1978, the partnership, under a deed in lieu of foreclosure, conveyed the shopping center to Freedom Mall Associates, Inc., a Delaware corporation, an agent or instrumentality of the lender, First National Bank of Chicago and/or First National Realty Services Corp. for $100.00 plus the mortgage. The conveyance was a conveyance to or for the benefit of, and at the direction of, the lender. (App., infra, p. 3a-4a, 79a)

The partnership reported the transfer of the shopping center on its

1978 partnership income tax return in the following manner:

Gross sales price		$,6,992,807.63
Cost or other basis	$6,731,963.86	
Less depreciation	723,057.84	
Adjusted cost basis		6,008,906.02
Gain		$ 983,901.61

(App., infra, p. 79a)

Only in a technical sense was a "paper" gain realized by the partnership by reason of the conveyance in lieu of foreclosure, due to the recapture of previous losses, i.e., depreciation [which had lowered cost basis] and accrued items, e.g. interest, which had generated the losses. No "real" tax benefit, for North Carolina purposes, was ever realized by Petitioner or the other partners from the operation of the shopping center. (App., infra, p. 6a)

During the period 1975 through 1978, the cumulative partnership net operating

losses were $983,901.61 and the technical gain in the year 1978 was $983,901.61. With the addition of other income in the amount of $196.59, the partnership's 1978 North Carolina return reflected total income of $984,098.20. After interest and other expenses of $28,590.70, the partnership reported net income of $955,507.50 and filed its 1978 North Carolina partnership return accordingly. (App., infra, p. 4a and 80a) On the partnership return, Petitioner's distributive share of net income of $257,987.03 was offset by his accumulated distributive shares of net operating losses of $257,987.03 for the years 1975, 1976 and 1977. (App., infra, p. 4a and 80a)

Petitioner filed a timely North Carolina individual income tax return for the taxable year 1978 and reported

$257,987.00 as his distributive share of the net income of Freedom Mall for 1978. As a deduction from this income, Petitioner claimed a carryover loss of $257,987.00, representing his accumulated distributive shares of the partnership's net operating losses for the years 1975, 1976 and 1977. As a result, Petitioner's 1978 return reflected adjusted gross income of $0 and no tax due. (App., infra, p. 4a-5a, 69a, 80a-81a)

Petitioner, domiciled in Montgomery, Alabama, derived substantial income from sources outside North Carolina for each of the years 1975, 1976 and 1977, respectively, of $118,056.00, $283,758.00 and $488,908.00. No part of such income was subject to North Carolina taxes. (App., infra, p. 3a and 80a)

On examination of Petitioner's 1978

North Carolina individual income tax return, the North Carolina Department of Revenue disallowed Petitioner's claimed deduction for carryover loss of $257,987.00. The deduction was disallowed on the grounds that under North Carolina General Statute §105-147 (9)d 2 Petitioner had not shown he sustained net economic losses in each of the years 1975, 1976 and 1977 in that his income derived from outside North Carolina for each of such years, respectively, exceeded his distributive share of the partnership's net operating losses. Consequently, the Department determined Petitioner's entire distributive share of partnership net income of $257,987.00 was taxable by the State of North Carolina in 1978. (App., infra, p. 5a)

By Notice of Income Tax Adjustment

mailed on May 21, 1980, the Department proposed an assessment of individual income tax for the year 1978 against Petitioner in the amount of $17,839.09, plus interest based upon Petitioner's North Carolina net taxable income. (App., infra, p. 6a, 69a-70a, 81a)

The Department directly and specifically reduced Petitioner's distributive share of the partnership's net operating losses for the years 1975, 1976 and 1977 by income derived from outside North Carolina. (App., infra, p.5a) In so doing, income constitutionally beyond the power of the state of North Carolina to tax was thus the express and only reason Petitioner's 1978 carryover loss was disallowed. (App., infra, p. 5a)

2. ADMINISTRATIVE PROCEEDINGS.

Petitioner filed a timely protest to

the Department's proposed assessment and requested a hearing before the Secretary of Revenue of North Carolina pursuant to North Carolina General Statute §105-241.1. The Petitioner asserted he realized no income subject to North Carolina income tax in 1978 and the State of North Carolina was seeking to impose its income tax on nonresident income in violation of legislative and constitutional authority. (App., infra, p. 6a and 70a)

The matter was initially heard by the Secretary of Revenue on May 12, 1981. (App., infra, p. 70a) By a Final Decision made and entered on August 4, 1981, The Secretary of Revenue sustained the assessment for 1978 in its entirety on the grounds that Petitioner realized taxable income of$257,987.00 in 1978 as his distributive share of the net income of Freedom Mall for the taxable year 1978.

Petitioner was held not to have sustained a "net economic loss" in 1975, 1976 or 1977 because his income derived from outside North Carolina for each of those years exceeded his distributive shares of the net operating losses of Freedom Mall. (App., infra, p. 6a and 70a)

Petitioner appealed the Secretary of Revenue's Final Decision dated August 4, 1981 to the Tax Review Board of North Carolina, contending evidence of the fair market value of the property was necessary to determine his liability for the tax based upon the intervening holding of the United States Court of Appeals for the Fifth Circuit in Tufts v. Commissioner of Revenue, 651 F.2d 1058 (1981). Because such evidence was not in the record, the matter was remanded to the Secretary of Revenue April 7, 1982 for rehearing. (App., infra, p. 70a-71a)

Prior to the rehearing, the United States Supreme Court reversed the decision of the Fifth Circuit in Tufts, supra, holding that when a taxpayer sells or disposes of property encumbered by a nonrecourse obligation exceeding the fair market value of the property, the full amount of the obligation assumed by the purchaser must be included in the amount realized from the sale and that the fair market value of the property is irrelevant. See Commissioner of Revenue v. Tufts, 461 U.S. 300, 75 L.Ed 2d 86, reh. denied, 463 U.S. 1215, 77 L.Ed.2d 1401 (1983). (App., infra, p. 7a, and 71a-72a) On remand Petitioner abandoned his contention that evidence of the fair market value of the property was necessary to determine his taxable gain in 1978. The sole issue on rehearing was whether there was legislative and

constitutional authority for reducing Petitioner's distributive shares of the partnership's net operating losses for the years 1975, 1976 and 1977 by income derived from outside North Carolina for each of such years in determining the amount of Petitioner's net economic loss to be carried over and deducted for 1978. (App., infra, p. 7a, and 72a) The matter was reheard by the Assistant Secretary of Revenue on May 14, 1984. (App., infra, p. 68a)

The Assistant Secretary of Revenue made and entered a Final Decision dated June 21, 1984. (App., infra, p. 68a-86a) The Assistant Secretary of Revenue sustained the assessment in its entirety based upon his determination that he lacked jurisdiction to consider the constitutionality of a statute and he concurred with the prior determination of

the Secretary of Revenue in the matter. (App., infra, p. 7a, and 85a-86a) The Assistant Secretary of Revenue held the following:

> "[I]n determining the amount of a net economic loss for any year, the statute clearly requires the taxpayer to reduce such loss by all of his income for the year, both taxable and nontaxable, including any income not subject to North Carolina income tax by virtue of the income having been received from sources outside North Carolina; and that in consequence thereof, the taxpayer did not sustain a net economic loss in 1975, 1976 or 1977 because his income from sources outside North Carolina during each of those years exceeded his distributive shares of the net operating losses of Freedom Drive Mall, Ltd."

(App., infra, p. 85a-86a)

Petitioner timely petitioned for review of the Assistant Secretary of Revenue's decision to the Tax Review Board of North Carolina. The matter was heard by the Tax Review Board on January 31, 1985. On the same date, the Tax

Review Board entered its Administrative Decision No. 212 in which the Board adopted the findings of facts and conclusions of law made by the Assistant Secretary of Revenue. The Board ordered that the decision of the Assistant Secretary of Revenue be affirmed in all respects. (App., infra, p. 7a, 64a-67a)

3. JUDICIAL PROCEEDINGS.

Petitioner timely petitioned the General Court of Justice, Superior Court Division, Wake County, North Carolina for review of Administrative Decision No. 212 of the Tax Review Board of North Carolina. (App., infra, p. 7a) The matter was heard at the May 27, 1986 Civil Non-Jury Session of Superior Court of Wake County, the Honorable James H. Pou Bailey presiding. (App., infra, p. 8a and 59a-60a) On May 29, 1986 Judge Bailey ordered Administrative Decision

No. 212 and the underlying assessment of the Department of Revenue be reversed and the costs of the proceeding be taxed against the State based upon the following conclusions of law:

> "1. The decision of the Tax Review Board and of the Assistant Secretary of Revenue, and the regulation (Title 17, North Carolina Administrative Code, Subchapter 6B, Rule .2604, April 6, 1984), result in the income taxation by the state of North Carolina of income earned by the taxpayer, a nonresident of North Carolina, in other states, and having no connection whatever with the state of North Carolina, and violates the due process clause (Amendment XIV, Section 1) of the Constitution of the United States, the commerce clause (Article I, Section 8, Cl. 3) of the Constitution of the United States, and the law of the land clause (Article I, Section 19) of the Constitution of the State of North Carolina.
>
> 2. The decision of the Tax Review Board and the Assistant Secretary of Revenue exceeds statutory authority and is legally erroneous, because G.S. §105-141(b) and §105-147(9)d2 and 3 do not support the Assistant Secretary's

interpretation of the statutes, which interpretation results in the taxation of non-North Carolina income of the nonresident taxpayer.

3. The interpretation of the pertinent statutes by the Secretary of Revenue appearing in the regulations above cited constitutes an attempt to tax the income of a nonresident taxpayer derived from activities in another state having no connection with the State of North Carolina, and is invalid because it is in violation of the due process clause (Amendment XIV, Section 1) of the Constitution of the United States, the commerce clause (Article 1, Section 8, Cl. 3) of the Constitution of the United States, and the law of the land clause (Article 1, Section 19) of the Constitution of the State of North Carolina.

4. The decision of the Tax Review Board and the Assistant Secretary of Revenue is arbitrary and capricious."

(App., infra, p. 8a, 60a-63a)

The term "law of the land" in Article 1, Section 19 of the North Carolina Constitution is synonymous with the term "due process" in the fourteenth

amendment to the United States Constitution. (See p.4-5) State v. Collins, 169 N. C. 323, 84 S.E. 1049 (1915); and State v. Ballance, 229 N. C. 764, 51 S.E 2d 731 (1949)

The trial court correctly determined that the decision of the Tax Review Board and of the Assistant Secretary of Revenue constituted an improper effort to levy North Carolina income tax on the out of state income of a nonresident individual. The Secretary of Revenue appealed Judge Bailey's decision to the Court of Appeals for North Carolina. (App., infra, p. 8a)

On appeal, the Court of Appeals in an unanimous decision affirmed the judgment of the trial court. (App., infra, p. 8a-9a, 41a-58a) The Court of Appeals affirmed the judgment of the trial court on the grounds: (1) the Secretary's construction of N.C.G.S.

§105-147(9)d2 to allow use of the nonresident taxpayer's non-North Carolina income to reduce his carryover losses in North Carolina was an indirect attempt to tax income not taxable by this state in violation of both federal due process and North Carolina's law of the land clause; and (2) the Secretary's interpretation of N.C.G.S. §105-147(9)d2 exceeded statutory authority as espoused in the general purpose clause of N.C.G.S. §105-134.

The Court of Appeals reviewed the United States Supreme Court's seminal decisions of Frick v. Pennsylvania, 268 U.S. 473, 69 L.Ed. 1058 (1925) and Maxwell v. Bugbee, 250 U.S. 525, 63 L.Ed. 1124 (1919). (App., infra, p. 52a-56a) The Court of Appeals stated that in Maxwell v. Bugbee, the Supreme Court upheld a New Jersey tax statute that

permitted the state to subject a nonresident decedent's estate to an inheritance tax at a rate which had the same ratio to the entire tax as the New Jersey property had to the entire estate. In Frick v. Pennsylvania, decided six years later, the Supreme Court struck down a Pennsylvania statute that permitted the state to include the value of a decedent's out of state property in calculating the value of the gross estate to be taxed. The Supreme Court reasoned that the plaintiff's tax liability was the same as if the state had taxed that which it did not have the power to tax. (App., infra, p. 52a-53a) The Supreme Court distinguished its holding in Frick v. Pennsylvania from that in Maxwell v. Bugbee on the basis that Maxwell v. Bugbee did not involve an attempt to tax local property on the value of the whole;

rather, the only bearing the property outside the state had on the tax was on the rate of tax imposed on property inside the state. Frick v. Pennsylvania, supra, 268 U.S. at 495-496.

The Court of Appeals held that in the present case, the rate of taxation does not vary. Instead, Petitioner's Alabama income is used to determine whether he even has income subject to taxation in North Carolina. (App., infra, p. 55a) The Court of Appeals grounded its decision on the Supreme Court's reasoning in Frick v. Pennsylvania, wherein the effect of the state's taxing scheme is the primary concern. (App., infra, p. 55a)

The Court of Appeals stated the following in affirming the judgment of the trial court:

> "When the effect of the statute is to make the taxpayer's tax liability the same as it would

> have been had the state included income it did not have the power to tax, then the scheme must fail. In the case at bar, Aronov would have no North Carolina tax liability in 1978 were it not for the fact that he had net income in Alabama during 1975, 1976 and 1977. Consequently, under the Secretary's interpretation of Sections 105-147(9)d2 and 3, his 1978 tax liability is what it would have been had his Alabama gains during the three preceding years been North Carolina gains. The result is a sophisticated scheme which taxes belatedly, the nonresident taxpayer's non-North Carolina income. The Secretary's interpretation of sections 105-147(9)d2 and 3 therefore violates the due process clause of the Fourteenth Amendment and the Law of the Land Clause of the North Carolina Constitution." (Emphasis added)

(App., infra, p. 55a-56a)

The Court of Appeals did not reach the question whether the Secretary of Revenue's interpretation violates the commerce clause of the United States Constitution. (App., infra, p. 58a)

The Secretary of Revenue appealed

the decision of the Court of Appeals to the Supreme Court of North Carolina on the basis of substantial questions arising under the Constitution of the United States and of North Carolina. (App., infra, p. 9a) Although the Court of Appeals declined to reach the question of whether the Secretary of Revenue's interpretation violated the commerce clause of the United States Constitution, Petitioner and Respondent argued this question on brief to the Supreme Court of North Carolina.

The Supreme Court of North Carolina acknowledged the present case presented an issue of first impression. (App., infra, p. 2a) In a majority opinion, the Supreme Court reversed the decision of the Court of Appeals. (App., infra, p. 1a-39a) The Court held that the Secretary's interpretation of North

Carolina General Statute §105-147(9)d2 does not violate the federal due process clause or the law of the land clause of the state constitution and does not exceed legislative authority. The Supreme Court did not address the question of whether the Secretary of Revenue's interpretation violated the federal commerce clause. (App., infra, p. 30a)

The Supreme Court of North Carolina also reviewed the United States Supreme Court's decisions in Frick v. Pennsylvania, supra, and Maxwell v. Bugbee, supra, and recognized them to be controlling in this case. The Supreme Court stated that a close reading of these decisions leads them to conclude that the Court of Appeals decision is erroneous because it is based upon a misunderstanding of the distinction

between them. (App., infra, p. 11a-12a) The Court stated they believed the facts of the present case are comparable to Maxwell v. Bugbee rather than to Frick v. Pennsylvania. The Court held that, contrary to the Court of Appeals' analysis, the Petitioner's Alabama income has not been used to determined whether he had income subject to taxation in North Carolina. (App., infra, p. 15a-16a) The Court stated that:

> "Both parties agree that the state has jurisdiction over the subject of the tax, the approximately $257,987 of income earned in North Carolina in 1978 from the taxpayer's distributive share of the shopping mall sale. The remaining computation is the measure of the tax, which is arrived at by using the taxpayer's Alabama income in 1975, 1976 and 1977 to reduce the deduction which he would otherwise have been granted for a net economic loss carry-over from $257,987 to $0.00."

(App., infra, p. 16a) However, the Supreme Court later states in its opinion

that:

> "the taxpayer's Alabama income is merely used to determine the amount of his properly taxable North Carolina income, which in turn determines the rate of the tax to be applied to that amount." (Emphasis added)

(App., infra, p. 18a-19a)

In a strongly worded and well reasoned dissent, Justice Martin correctly states that the majority's reasoning is a non sequitur in extending Maxwell v. Bugbee to the facts in the present case. (App., infra, p. 31a-39a) Justice Martin states in part as follows:

> "In the case before us we are involved with determining the amount of income subject to the statutorily established tax rate. Likewise, in Frick the United States Supreme Court was concerned with determining the amount or value of the property to be taxed.
>
> The majority also recognizes this distinction but inexplicably mischaracterizes the present case as more analogous to Maxwell than to Frick. It is clear to me that the state is not using the

Alabama income to determine the rate at which the North Carolina income will be taxed. The rates for individual income tax, ranging from two percent to seven percent, have already been set by statute. * * * Here the state seeks instead to use the Alabama income to increase the amount or value of North Carolina income to be taxed by eliminating a legitimate loss deduction. This is a far cry from the situation in Maxwell, where the value of nontaxable out-of-state property solely affected the rate of tax while the value of in-state property to be taxed remained the same. * * *

* * * [U]nder the majority's view, the taxpayer's liability is the same as it would have been had his Alabama income in 1975, 1976 and 1977 been North Carolina income. The majority's opinion is thus "the equivalent of saying that it was admissible to measure the tax by a standard which took no account of the distinction between what the State had power to tax and what it had no power to tax, and which necessarily operated to make the amount of the tax just what it would have been had the State's power included what was excluded by the Constitution." Frick at 494-95, 69 L. Ed. at 1064 (emphasis added). Such an approach is untenable because, as in Frick, "[i]t would open

the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail." Id. at 495, 69 L. Ed. 2d at 1064-65. An attempted taxation must fail "where the State exceeds its authority in imposing a tax upon the subject-matter within its jurisdiction in such a way as to really amount to taxing that which is beyond its authority." Maxwell at 539-40, 63 L. Ed. at 1131 (emphasis added).

The majority opinion now relies upon both Frick and Maxwell. In accord with Maxwell it states that "the taxpayer's Alabama income has not been used to determine whether he had income subject to taxation in North Carolina," arguing that the Alabama income was only used to determine the rate or increase of the tax to be applied. Later, the majority holds: "Here the taxpayer's Alabama income is merely used to determine the amount of his properly taxable North Carolina income..." Thus the majority first holds that the Alabama income was only used to determine the rate of the tax, but finally admits that it was used to determine the amount of income to be subject to taxation under the statutory rate schedule.

By allowing the Alabama

> income to be used to determine the amount of the taxpayer's taxable income, the majority opinion violates the constitutional mandates of Frick. The majority engages in the utmost sophistry in upholding a tax premised solely upon the existence of constitutionally protected out-of-state income."

(App., infra, p. 34a-38a)

REASONS FOR GRANTING THE WRIT

This case presents important questions of federal law regarding the constitutional limitations on a state's power to tax indirectly, by a device or scheme, the income of nonresident individual taxpayers earned outside the state and beyond its taxing power. This case presents the question of when has a state structured its tax statutes so as to tax a subject matter within its jurisdiction in such a way as to really amount to taxing that which is beyond its authority.

The opinion of the Supreme Court of

North Carolina is squarely in conflict with applicable decisions of this Court. The decision below upholds the Secretary of Revenue's construction of a state income tax statute which taxes indirectly income derived outside North Carolina in violation of the constitutional restrictions of the due process clause of the fourteenth amendment to the United States Constitution and the commerce clause of the United States Constitution.

1. THE DECISION BELOW CONFLICTS WITH THIS COURT'S PRECEDENTS UNDER THE DUE PROCESS CLAUSE OF THE FOURTEENTH AMENDMENT.

The decision below is contrary to this Court's decisions in Frick v. Pennsylvania, supra, and Maxwell v. Bugbee, supra.

In its majority opinion, the North Carolina Supreme Court correctly

identifies Frick v. Pennsylvania and Maxwell v. Bugbee as the two United States Supreme Court cases pertinent to the issue of whether the Secretary's interpretation of N.C. G.S. §105-147(9)d2 violates the due process clause of the fourteenth amendment to the United States Constitution. (App., supra, p. 11a) It is clear from a close reading of the majority's opinion, however, that the majority erred in applying the principles set out by the Court in Frick v. Pennsylvania and Maxwell v. Bugbee to this case.

As stated in Justice Martin's well reasoned dissent, the majority's reasoning is a non sequitur in extending Maxwell v. Bugbee to the facts in this case. This is even recognized by the majority. While the majority first holds Petitioner's Alabama income was

used only to determine the rate of tax on his North Carolina income, the majority finally admits Petitioner's Alabama income was used to determine the amount of income subject to taxation under the statutory rate schedule. (App., infra, p. 37a-38a)

In this case, the Secretary's construction of N.C. G.S. §105-147(9)d2 represents state action and the taking of property subject to the restrictions of the due process clause of the fourteenth amendment of the United States Constitution. Frick v. Pennsylvania, supra, 268 U.S. at 488-89. See Tulsa Professional Collection Services, Inc. v. Pope, 485 U.S. _____, 99 L.Ed.2d 565 (1988), involving Oklahoma's nonclaim statute.

The Secretary's construction of N.C. G.S. §105-147(9)d2 represents a patently

unconstitutional standard of applying out of state income to reduce Petitioner's distributive shares of the partnership's net operating losses for the years 1975, 1976 and 1977, thereby eliminating Petitioner's carryover loss deduction in 1978. Plainly the Secretary's construction results in a tax premised solely upon the existence of constitutionally protected out of state income. Even under the Secretary's construction, if Petitioner had no income derived from outside North Carolina in the years 1975, 1976 and 1977, the loss deduction in 1978 would have been allowed.

A. FRICK V. PENNSYLVANIA

In Frick v. Pennsylvania, supra, decided six years after Maxwell v. Bugbee, supra, this Court was confronted

with a Pennsylvania inheritance statute which included the value of the decedent's out of state property in calculating the value of the gross estate to be taxed. The concern in Frick v. Pennsylvania was that property beyond Pennsylvania's taxing authority was used to determine and calculate the amount of property subject to tax, not the rate of taxation. Id. at 495-96. The Pennsylvania statute did not provide for an apportionment of the taxes calculated, based upon the ratio of the decedent's in state property to the decedent's entire estate, as was the case in Maxwell v. Bugbee.

This Court struck down the Pennsylvania statute as violative of the due process clause of the fourteenth amendment to the United States Constitution. The Court distinguished

the Pennsylvania statute from the tax statute in Maxwell v. Bugbee and limited the holding in Maxwell v. Bugbee to its specific facts. The Court stated Maxwell v. Bugbee was on the border line, as evidenced by the dissent of four members of the Court, and that there was no attempt, as in the case before it, to compute the tax in respect of the part within the state on the value of the whole. Frick v. Pennsylvania, 268 U.S. at 495-96. The Court further stated that the Court in Maxwell v. Bugbee distinctly recognized the state's power was subject to constitutional limitations, including the due process clause of the fourteenth amendment to the United States Constitution, and it would be a violation of that clause for a state to impose a tax on a thing within its jurisdiction in such a way as to really amount to taxing

that which is beyond its authority. Id. at 496. As stated by the Court:

> "One ground on which the state court put its decision was that, in taxing the transfer of the property which the decedent owned in Pennsylvania, it was admissible to take as a basis for computing the tax the combined value of that property and the property in New York and Massachusetts. Of course, this was but the equivalent of saying that it was admissible to measure the tax by a standard which took no account of the distinction between what the State had power to tax and what it had no power to tax, and which necessarily operated to make the amount of the tax just what it would have been had the State's power included what was excluded by the Constitution. This ground, in our opinion, is not tenable. It would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail." (Emphasis added)

Id., at 494-95.

Under the Pennsylvania statute considered in Frick v. Pennsylvania, property outside Pennsylvania's taxing

power was used to directly determine and calculate the bottom line, i.e. the amount of property taxed. The same situation prohibited in Frick v. Pennsylvania, in effect, occurs under the Secretary's construction of N.C. G.S. §105-147(9)d2 in that Petitioner's Alabama income, through the elimination of an otherwise allowable deduction, is used to directly determine the amount of income subject to tax in 1978.

B. MAXWELL V. BUGBEE

In Maxwell v. Bugbee, supra, the taxpayer challenged on due process grounds a New Jersey inheritance statute which set the tax rate for the transfer of in state property by determining the ratio of that property to the decedent's entire estate, wherever situated. The statute provided for a tax graduated in

rate according to the value of the entire estate, and required that where the estate was partly within and partly without the state, the transfer of the part within should bear a proportionate part of what according to the graduated rate would be the tax on the whole. The only bearing which the property without the state had on the tax imposed in respect of the property within was that it effected the rate of tax. Id., 250 U.S. at 533-34.

The concern in Maxwell v. Bugbee was that applying the state's apportionment formula resulted, in the cases under review, in a greater tax on the transfer of property of the estates subject to the jurisdiction of New Jersey, then would be assessed for the transfer of an equal amount, in a similar manner, of property of a decedent who died a resident of New

Jersey. This inequity arose because of imposing the graduated tax rate upon estates as large as those under review. Id. at 534.

This Court upheld the New Jersey statute, holding that when "the state levies taxes within its authority, property not in itself taxable by the state may be used as a measure of the tax imposed." Id. at 539. The Court also referred to the limitations on a state's power to tax property beyond its jurisdiction, stating the following:

> "In the present case the state imposes a privilege tax, clearly within its authority, and it has adopted as a measure of that tax the proportion which the specified local property bears to the entire estate of the decedent. That it may do so, within limitations which do not really make the tax one upon property beyond its jurisdiction, the decisions to which we have referred clearly establish.
>
> * * *

> It is only in instances in which the state exceeds its authority in imposing a tax upon a subject matter within its jurisdiction in such a way as to really amount to taxing that which is beyond its authority, that such exercise of power by the state is held void. In cases of that character the attempted taxation must fail."

Id. at 539-40.

Maxwell v. Bugbee was concerned with the determination of the tax rate to be applied to the property within the jurisdiction and power of New Jersey to tax. Under the New Jersey taxing formula, property outside the state's taxing powers is not used in any manner to determine and calculate the amount of the property to be taxed.

In this case, it is clear the Secretary's construction of North Carolina General Statute §105-147(9)d2 does not affect the tax rate to be applied to Petitioner's North Carolina

income but actually determines the amount of income to be taxed. The Secretary of Revenue's construction imposes a tax on Petitioner's 1978 North Carolina income in such a way as to really amount to taxing belatedly Petitioner's non-North Carolina income derived in the years 1975, 1976 and 1977. The Supreme Court of North Carolina erred in finding the facts in this case comparable to those in Maxwell v. Bugbee rather than in Frick v. Pennsylvania.

C. THERE IS NO CONNECTION BETWEEN PETITIONER'S OUT OF STATE INCOME AND HIS IN STATE LIMITED PARTNERSHIP INTEREST.

The Supreme Court of the United States has given "consistent adherence to the time honored concept: that due process requires some definite link, some minimum connection, between a State and

the person, property or transaction it seeks to tax." Miller Bros. v. Maryland, 347 U.S. 340, 344-345, 98 L.Ed. 744 (1954).

In a more recent case, ASARCO, Inc. v. Idaho State Tax Comm., 458 U.S. 307, 73 L.Ed.2d 787 (1982), this Court reiterated the general principle under due process analysis, that a State may not tax value earned outside its borders. The broad inquiry is whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the State has given anything for which it can ask return. Id., at 315.

In this case, all of the Petitioner's income earned in the years 1975, 1976 and 1977 related to his ownership, management and control of

businesses and activities carried on outside of North Carolina. Therefore, the "definite link" or "minimum connection" required by the due process clause to sustain the use of such income to reduce Petitioner's distributive shares of the partnership's net operating losses for such years is missing. The Secretary's use of Petitioner's out of state income in such manner results in an indirect tax, but a tax nonetheless, on income which North Carolina has no power to tax.

The fact Petitioner engaged in membership in a limited partnership in North Carolina does not warrant taxation of the income from his separate and unrelated businesses and activities conducted entirely outside of North Carolina. The apportionment and taxation of such income by the device or scheme of

reducing his distributive share of the partnership's net operating losses by such income clearly violates the due process clause of the fourteenth amendment to the Constitution of the United States, in accord with ASARCO, Inc. v. Idaho State Tax Comm., supra.

In this case, the position of the Secretary of Revenue, of offsetting North Carolina net economic losses against all income, whether within or outside North Carolina, exceeds constitutional authority because it has the effect of taxing income earned outside North Carolina which has no connection with North Carolina. Such practice is contrary to the constitutional limitations on a state's power to tax value earned outside its borders, as explained by this Court in ASARCO, Inc. v. Idaho State Tax Commission, supra.

The Secretary's construction of N.C.G.S. §105-147(9)d2 has converted a loss into a profit, which has either been created out of nothing or has been appropriated by North Carolina from another State. As correctly recognized by the Court of Appeals and Justice Martin in his dissent, Petitioner's 1978 tax liability is what it would have been had his Alabama gains in 1975, 1976 and 1977 been North Carolina gains. (App., infra, p. 35a-36a, 55a-56a) The North Carolina Supreme Court failed to discuss and distinguish this case from ASARCO, Inc. v. Idaho State Tax Commission, supra.

2. THE DECISION BELOW CONFLICTS WITH THIS COURT'S PRECEDENTS UNDER THE COMMERCE CLAUSE.

In its majority opinion, the Supreme Court of North Carolina recognizes that

the trial court reversed Administrative Decision No. 212 and its underlying assessment, holding in part that it violated the commerce clause of the United States Constitution. The Court further recognizes that the Court of Appeals declined to reach this question. The Court also declined to address this question although it was properly before it.

Because of the posture of this case on this issue when it reached the Supreme Court of North Carolina, the Court, by not addressing this question, in effect, has reversed the decision of the trial court on this issue and has held the Secretary's construction of N.C.G.S. §105-147(9)d2 does not violate the commerce clause of the United States Constitution. This decision is contrary to this Court's precedents under the

commerce clause.

In determining whether a state tax offends the commerce clause of the Constitution of the United States, it must be evaluated under the four-part test enunciated by this Court in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 51 L.Ed.2d 326 (1977). Commonwealth Edison v. Montana, 453 U.S. 609, 69 L.Ed. 2d 884 (1981). Under this test, a state tax does not offend the commerce clause if it:

1. is applied to an activity with a substantial nexus with the taxing State,

2. is fairly apportioned,

3. does not discriminate against interstate commerce, and

4. is fairly related to services provided by the State.

Complete Auto Transit, Inc. v. Brady, supra, at 287; and Commonwealth Edison

Co. v. Montana, supra, at 617.

In reviewing commerce clause challenges to state taxes, the goal of this Court has been to establish a consistent and rational method of inquiry focusing on the "practical effect of a challenged tax." Commonwealth Edison Co. v. Montana, supra, at 616.

In our case, the obvious and practical effect of reducing Petitioner's distributive share of partnership net operating losses each year by his income derived from outside North Carolina is to tax such income. Clearly the Secretary's construction of N.C.G.S. §105-147(9)d2 violates each part of the test, enunciated in Complete Auto Transit, Inc. v. Brady, supra:

1. the tax is applied to an activity (income derived outside North Carolina) having no nexus or connection

with the state;

2. the tax is apportioned wholly to income derived outside North Carolina;

3. the tax discriminates against interstate commerce in that it denies a deduction to a nonresident taxpayer that would be allowable to a resident taxpayer; and

4. the tax is not related to services provided by the state with respect to Petitioner's out of state income.

In Westinghouse Electric Corporation v. Tully, 466 U.S. 388, 80 L.Ed.2d 388, (1984), the issue before this Court was whether the State of New York, in the manner in which it allowed corporations a tax credit on the accumulated income of their subsidiary DISCs (Domestic International Sales Corporation), discriminated against export shipping

from other states, in violation of the commerce clause. This Court held that the manner in which New York multiplied the allowable credit by the New York export ratio of the DISC was both inaccurate and duplicative with respect to the fair apportionment of the credit. Id. at 399. This adjustment had the effect of treating differently parent corporations that are similarly situated in all respects except for the percentage of their DISC's shipping activities conducted from New York. Id. at 400.

This Court held that it was irrelevant that New York discriminated against a business carried on outside the state by disallowing a tax credit rather than by imposing a higher tax. The discriminatory economic effect would be identical. "We have declined to attach any constitutional significance to such

formal distinctions that lack economic substance." Id. at 404-405, citing Maryland v. Louisiana, 451 U.S. 725, 68 L.Ed.2d 576 (1981).

In this case, the Secretary of Revenue has discriminated against the Petitioner by disallowing a deduction rather than a tax credit. The practical and economic effect of reducing Petitioner's distributive net operating losses for 1975, 1976 and 1977 by his income derived from outside the state is to tax such income.

Petitioner also refers this Court to two of its more recent commerce clause decisions: Tyler Pipe Industries, Inc. v. Washington State Department of Revenue, 483 U.S. _____, 97 L.Ed.2d 199 (1987) [involving Washington's manufacturing tax]; and American Trucking Association, Inc. v. Scheiner, 483 U.S.

__, 97 L.Ed.2d 226 (1987) [involving two Pennsylvania taxes on the operation of trucks on Pennsylvania's highways]. The Court, relying on Armco, Inc. v. Hardesty, 467 U.S. 638, 81 L.Ed.2d 540 (1984), and Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 77 L.Ed.2d 545 (1983), held the taxes at issue in these cases were violative of the commerce clause.

CONCLUSION

For the foregoing reasons, this petition for writ of certiorari should be granted and the decision below reversed.

Respectfully submitted,

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January, 1989

APPENDIX A

IN THE SUPREME COURT OF NORTH CAROLINA

AARON ARONOV	)	
	)	
v.	)	No. 336PA87
	)	Wake
SECRETARY OF REVENUE, DEPARTMENT OF REVENUE STATE OF NORTH CAROLINA	)	

Appeal by the Secretary of Revenue from a unanimous decision of the Court of Appeals, 85 N.C. App. 677, 355 S.E.2d 854 (1987), affirming the Order reversing Final Administrative Decision No. 212 of the Tax Review Board, entered by Bailey, J., at the 27 May 1986 Civil Non-Jury Session of Superior Court, Wake County. Heard in the Supreme Court 15 October 1987.

LAW OFFICES OF KENNETH G. ANDERSON, by Kenneth G. Anderson and James P. Stevens, and HUNTER, WHARTON & HOWELL, by John V. Hunter, III, for plaintiff-appellee.

LACY H. THORNBURG, Attorney General, by Newton G. Pritchett, Jr., Assistant Attorney General, for appellants Secretary of

Revenue, Department of Revenue, and State of North Carolina.

MEYER, Justice.

This case presents an issue of first impression. We decide whether the Secretary of Revenue's requirement that a nonresident taxpayer reduce his distributive share of his North Carolina partnership's net operating loss each year by his non-North Carolina income has the effect of imposing a tax on that income in violation of constitutional and legislative authority. The Court of Appeals resolved the issue in favor of the taxpayer. We reverse.

During the years 1975 through 1978, Aaron Aronov (hereinafter "the taxpayer") was a nonresident of North Carolina, domiciled and residing in Montgomery, Alabama, but doing business in North Carolina as a limited partner in Freedom Drive Mall, Ltd., a limited partnership

which operated a shopping center in Charlotte, North Carolina. For each of the taxable years 1975, 1976 and 1977, the partnership realized net operating losses of $195,438.62, $309,789.78 and $450,279.10 respectively. The taxpayer's distributive share of the partnership losses was $52,768.43 in 1975, $83,643.24 in 1976 and $121,575.36 in 1977. The taxpayer derived substantial income from sources outside North Carolina for those years, however, in the amounts of $118,056, $283,758 and $488,908 respectively.

The shopping center was unsuccessful and the lender, First Chicago Realty Corporation, sought to acquire the property under a deed in lieu of foreclosure. On 1 March 1978, the partnership sold its interest in the shopping center to Freedom Mall

Associates, Inc., an agent of the lender, for the consideration of $100.00 and cancellation of the partnership's indebtedness, which had been secured by a deed of trust on the property to the lender.

During the taxable year 1978, the partnership realized a total income of $984,098.20, which included the gain from the cancellation of the debt upon sale of the shopping center. After deducting interest and other expenses, the partnership realized a net income of $955,507.50, as reflected in its 1978 tax return. The taxpayer's distributive share of the net taxable income for that year was $257,987.03.

The taxpayer reported $257,987 as his distributive share on his 1978 North Carolina individual income tax return. As a deduction from this income, he

claimed a carryover loss of $257,987, representing his accumulated distributive shares of the partnership's net operating losses for the years 1975, 1976 and 1977. As a result, the taxpayer's 1978 return reflected adjusted gross income of $0.00 and no tax due.

The Department of Revenue disallowed the taxpayer's claimed deduction on the grounds that under N.C.G.S. §105-147(9)(d)(2) the taxpayer had not shown that he had sustained net economic losses in 1975, 1976 and 1977, because his income from all sources in those years, including any income not taxable under North Carolina's individual income tax laws, exceeded his distributive share of the partnership's net operating losses in 1975, 1976 and 1977. By Notice of Income Tax Adjustment, the Department proposed an assessment for 1978 of $17,839.09 plus

interest, based on the taxpayer's North Carolina net taxable income. The taxpayer requested a hearing before the Department of Revenue. At the hearing, he contended that the income he had reported from the sale of the shopping center was only a "technical" gain, and that requiring him to reduce his distributive share of the partnership's loss each year by his non-North Carolina income had the effect of imposing a tax on that income in violation of both legislative and constitutional authority. On 4 August 1981, the Secretary of Revenue (hereinafter "Secretary") entered a Final Decision which sustained the assessment for 1978 in its entirety.

The taxpayer appealed the Final Decision to the Tax Review Board, which initially remanded the matter to the Secretary based on a decision of the

United States Court of Appeals for the Fifth Circuit not pertinent to the question presented here because of an intervening reversal by the United States Supreme Court. Commissioner of Revenue v. Tufts, 461 U.S. 300, 75 L. Ed. 2d 86, reh'g denied, 463 U.S. 1215, 77 L. Ed. 2d 1401 (1983). On rehearing before the Assistant Secretary of Revenue, the taxpayer renewed his contentions as above. On 21 June 1984, the Assistant Secretary entered a Final Decision sustaining the assessment in its entirety. The matter was subsequently reviewed by the Tax Review Board. On 31 January 1985, the Board entered Administrative Decision No. 212, which affirmed the Assistant Secretary of Revenue's Final Decision in all respects.

The taxpayer then petitioned for review in Superior Court. The trial

court, sitting without a jury, reversed Administrative Decision No. 212 and its underlying assessment, concluding that (1) it violated the due process and commerce clauses of the United States Constitution as well as the law of the land clause of the North Carolina Constitution, (2) it exceeded statutory authority and was legally erroneous, and (3) it was arbitrary and capricious.

The Secretary appealed. The Court of Appeals affirmed the judgment of the trial court on the grounds that (1) the Secretary's construction of N.C.G.S. §105-147(9)(d)(2) to allow use of the nonresident taxpayer's non-North Carolina income to reduce his carryover losses in North Carolina was an indirect attempt to tax income not taxable by this state in violation of both federal due process and North Carolina's law of the land clause;

and (2) the Secretary's interpretation of N.C.G.S. §105-147(9)(d)(2) exceeded statutory authority as espoused in the general purpose clause of N.C.G.S. §105-134. The Court of Appeals declined to reach the question of whether the Secretary's interpretation violated the federal commerce clause. The Secretary appealed to this Court on the basis of substantial questions arising under the Constitutions of the United States and of North Carolina.

I.

We first address the question of whether the Secretary's interpretation of N.C.G.S. §105-147(9)(2) violates the federal due process clause or the law of the land clause of the state constitution. The Court of Appeals determined that the Secretary's interpretation of the statute

resulted in "a sophisticated scheme which taxes belatedly, the nonresident taxpayer's non-North Carolina income." Aronov v. Sec. of Revenue, 85 N.C. App. 677, 682, 355 S.E.2d 854, 857.

N.C.G.S. §105-147(9)(d)(2) provides as follows:

> The net economic loss for any year shall mean the amount by which allowable deductions for the year other than personal exemptions, nonbusiness deductions and prior year losses shall exceed income from all sources in the year including any income not taxable under this Division.

N.C.G.S. §105-147-(9)(d)(2) (1985) (emphasis added). The Secretary has interpreted the emphasized language to require that

> [i]f a nonresident with income taxable to North Carolina and also with income not taxable to North Carolina has a loss on the North Carolina income, he must reduce the loss by the income not taxable to North Carolina under this division before he may carry the loss over to the ensuing

year.

N.C. Admin. Code tit. 17, r. 6B.2604 (February 1976).

Because the term "law of the land" in article 1, section 20 (sic) of the North Carolina Constitution is synonymous with the term "due process of law" in the fourteenth amendment to the United States Constitution, see, e.g., Transportation Co. v. Currie, Comr. of Revenue, 248 N.C. 560, 104 S.E.2d 403 (1958), aff'd, 359 U.S. 28, 3 L. Ed. 2d 625 (1959), we are aided in our review by two cases from the United States Supreme Court. Frick v. Pennsylvania, 268 U.S. 473, 69 L. Ed. 1058 (1925); Maxwell v. Bugbee, 250 U.S. 525, 63 L. Ed. 1124 (1919). A close reading of these decisions leads us to conclude that the Court of Appeals' determination is erroneous because it is based upon a misunderstanding of the

distinction between them.

The law is well settled that states have the power to tax nonresidents on income derived from sources within the state. Shaffer v. Carter, 252 U.S. 37, 64 L. Ed. 445 (1920); Travis v. Yale & Towne Mfg. Co., 252 U.S. 60; 64 L. Ed. 460 (1920). Indeed, where jurisdiction to tax exists, states enjoy broad authority to determine the method and extent of taxation. Wisconsin v. J. C. Penney Co., 311 U.S. 435, 85 L. Ed. (1940). Moreover, when a state levies taxes within its authority, property not in itself taxable by the state may be used as a measure of the tax imposed. Maxwell v. Bugbee, 250 U.S. 525, 63 L. Ed. 1124. At issue in Maxwell was a New Jersey statute which allegedly taxed the transfer of property, whether in or out of state, of resident and non-resident

decedents. The amount of tax depended on the ratio of the New Jersey property to the entire estate wherever situated, but the tax was levied only upon property actually located within New Jersey. Maxwell contended that the effect of including the property beyond the jurisdiction of New Jersey in measuring the tax levied in New Jersey amounted to a deprivation of property without due process of law. The Supreme Court concluded:

> [T]he subject matter here regulated is a privilege to succeed to property which is within the jurisdiction of the State. When the state levies taxes within its authority, property not in itself taxable by the State may be used as a measure of the tax imposed...In the present case, the State imposes a privilege tax, clearly within its authority, and it has adopted as a measure of that tax the proportion which the specified local property bears to the entire estate of the decedent...It is in no just sense a tax upon the foreign property.

Id. at 539, 63 L. Ed. at 1131 (emphasis added).

In contrast, in Frick v. Pennsylvania, 268 U.S. 473, 69 L. Ed. 1058, upon which the Court of Appeals relied, the Supreme Court held that the state had no constitutional power to levy an inheritance tax based upon real and personal property wherever located. By including the value of tangible personal property located outside the state in the Pennsylvania decedent's gross estate for the purpose of applying an inheritance tax on the whole estate, the Pennsylvania statute "in so far as it attempt[ed] to tax the transfer of tangible personalty having an actual situs in other States, contravene[d] the due process of law clause of the Fourteenth Amendment and [was] invalid." Id. at 496, 69 L. Ed. at 1065. The

Supreme Court distinguished this holding from Maxwell on the basis that Maxwell did not involve an attempt to tax local property on the value of the whole; rather, the only bearing the property outside the state had on the tax was on the rate of tax imposed on property inside the state. Id.

The essential distinction between Maxwell and Frick, then, is that in the latter case, the subject of the tax was personal property located in other states and therefore not within Pennsylvania's jurisdiction, but in the former, the subject of the tax was within New Jersey's jurisdiction. In Maxwell, the nontaxable property was used only as a measure of the tax imposed on the property located in New Jersey. We believe that the facts in the case before us are comparable to Maxwell rather than

to Frick. Here, contrary to the Court of Appeals' analysis, the taxpayer's Alabama income has not been used to determine whether he had income subject to taxation in North Carolina. Both parties agree that the state has jurisdiction over the subject of the tax, the approximately $257,987 of income earned in North Carolina in 1978 from the taxpayer's distributive share of the shopping mall sale. The remaining computation is the measure of the tax, which is arrived at by using the taxpayer's Alabama income in 1975, 1976 and 1977 to reduce the deduction which he would otherwise have been granted for a net economic loss carry-over from $257,987 to $0.00.

Deductions are privileges, not rights. They are benefits which the state gratuitously confers. See Maxwell v. Bugbee, 250 U.S. 525, 63 L. Ed. 1124;

Rubber Co. v. Shaw, Comr. of Revenue, 244 N.C. 170, 92 S.E.2d 799 (1956); Ward v. Clayton, Com'r of Revenue, 5 N.C. App. 53, 167 S.E.2d 808 (1969), aff'd, 276 N.C. 411, 172 S.E.2d 531 (1970). The state has the concomitant power to limit those benefits. When the state levies taxes within its jurisdiction, income not in itself taxable by that state may therefore be used as a measure of the tax imposed without violating the due process clause of the fourteenth amendment. Maxwell v. Bugbee, 250 U.S. 525, 63 L. Ed. 1124; see also Great Atlantic and Pacific Tea Co. v. Grosjean, 301 U.S. 412, 81 L. Ed. 1193 (1937).

This Court has itself considered the issue in the context of inheritance taxes. Rigby v. Clayton, Comr. of Revenue, 274 N.C. 465, 164 S.E.2d 7 (1968). There we held that the levy of an inheritance tax

upon the transfer of property within North Carolina at a rate which considered the decedent's estate wherever situated did not violate the federal due process clause or the state law of the land clause. We adopted the Court of Appeals' reasoning that Frick sustained the validity of Maxwell by "recognizing the difference between an attempt to tax succession to property within the State in an amount computed on the value of the entire estate wherever located...and a statute which merely uses the value of the entire estate wherever located to determine the rate of tax to be applied." Rigby v. Clayton, Comr. of Revenue, 2 N.C. App. 57, 63, 162 S.E.2d 682, 685 (1968). In the case sub judice, we continue to recognize the distinction between Frick and Maxwell. Here the taxpayer's Alabama income is merely used

to determine the amount of his properly taxable North Carolina income, which in turn determines the rate of the tax to be applied to that amount. We conclude that the requirement that the taxpayer reduce his North Carolina carryover losses by his non-North Carolina income does not result in "a sophisticated scheme" which "belatedly" taxes the non-North Carolina income.

We hold that the Secretary's interpretation of N.C.G.S. §105-147(9)(d)(2) does not violate either the due process clause of the United States Constitution or the law of the land clause of the North Carolina Constitution.

II.

We now consider whether the Secretary's interpretation of N.C.G.S.

§105-147(9)(d)(2) exceeds legislative authority. See N.C.R. App. P. 16(a) (1988). We conclude that it does not.

With respect to a person who is a nonresident of North Carolina, N.C.G.S. §105-136 imposes a progressive rate of tax

> upon the net income derived from North Carolina sources of every nonresident individual which is attributable to the ownership of any interest in real or tangible personal property in this State or which is due from a business, trade, profession, or occupation carried on in this State.

N.C.G.S. §105-136 (1985). "Net income" is defined as a taxpayer's gross income less the deductions allowed by law. N.C.G.S. §105-140 (1985). Both the Secretary and the taxpayer agree that the taxpayer had a North Carolina taxable gross income of approximately $257,987 in 1978. The question to be answered, therefore, is whether the Secretary's

requirement in N.C. Admin. Code tit. 17, r. 6B.2604 that the taxpayer reduce his North Carolina carryover losses by his non-North Carolina income exceeds legislative authority.

In answering this question we are mindful of several basic rules of statutory construction in the tax area. Deductions, such as that authorized in N.C.G.S. §105-147(9)(d)(2), are in the nature of exemptions: they are privileges, not rights, and are allowed as a matter of legislative grace. Ward v. Clayton, 5 N.C. App. 53, 167 S.E.2d 808 (1969), aff'd, 276 N.C. 411, 172 S.E.2d 531 (1970). When a statute provides for an exemption from taxation, any ambiguities therein are resolved in favor of taxation. In re Clayton-Marcus Co., 286 N.C. 215, 210 S.E.2d 199 (1974). "The underlying premise when interpreting

taxing statutes is: 'Taxation is the rule; exemption the exception.'" Realty Corp. v. Coble, Sec. of Revenue, 291 N.C. 608, 611, 231 S.E.2d 656, 658 (1977) (quoting Odd Fellows v. Swain, 217 N. C. 632, 637, 9 S.E.2d 365, 368 (1940)). A statute providing exemption from taxation is strictly construed against the taxpayer and in favor of the State. Food House, Inc. v. Coble, Sec. of Revenue, 289 N.c. 123, 221 S.E.2d 297 (1976). In all tax cases, the construction placed upon the statute by the Secretary (then the Commissioner) of Revenue, although not binding, will be given due consideration by a reviewing court. Campbell v. Currie, Commissioner of Revenue, 251 N.C. 329, 111 S.E.2d 319 (1959).

We also find guidance in analogous case law. In Dayton Rubber Co. v. Shaw,

Comr. of Revenue, 244 N.C. 170, 92 S.E.2d 799 (1956), we addressed this issue with respect to corporations. There the Commissioner reduced the carryover loss of a foreign corporation doing business in North Carolina by royalty income that the corporation received which was not taxable in this state. In upholding the inclusion of nontaxable income in arriving at an allowable deduction for carryover purposes as required by N.C.G.S. §105-147(6)(d) (now similarly codified as N.C.G.S. §105-147(d)(2) and (d)(3)), we stated:

> It is also conceded by the defendant that the royalty income of the plaintiff in 1949 and 1950 was from non-unitary business operations having no relation or connection with the plaintiff's manufacturing activities in North Carolina. Thus, it is clear that no part of it could be taxed as income in North Carolina. <u>However, including this nontaxable income, in arriving at an allowable deduction for carryover purposes to be</u>

> deducted from taxable income in a succeeding year, is, in our opinion, required by G.S. 105-147(6)(d), and we so hold.
>
> Our Legislature was under no constitutional or other legal compulsion to allow any carryover to be deducted from taxable income in a future year. It enacted the carryover provisions purely as a matter of grace, gratuitously conferring a benefit but limiting such benefit to the net economic loss of the taxpayer after deducting therefrom the allocable portion of such taxpayer's nontaxable income.

Dayton Rubber Co. v. Shaw, Comr. of Revenue, 244 N.C. at 174, 92 S.E.2d at 802 (emphasis added). Nothing in the former statute limited its application to resident individuals and foreign and domestic corporations. Moreover, the second paragraph of the statute provided:

> [T]he net economic loss for any year shall mean the amount by which allowable deductions for the year other than contributions, personal exemptions, prior year losses, taxes on property held for personal use, and interest on debts incurred for personal

> rather than business purposes shall exceed income from all sources in the year including any income not taxable under this article.

N.C.G.S. §105-147(6)(d) (1961) (emphasis added). The differences between this former statute and N.C.G.S. §105-147(9)(d)(2) and (d)(3) are formal, not substantive. Similarly, nothing in the present statute limits its application to resident individuals. Neither do we find anything in the language of Dayton Rubber Co. which confines its rationale and holding to the unitary method of apportionment, foreign corporations or interstate businesses as the taxpayer contends.

In Manufacturing Co. v. Clayton, Acting Comr. of Revenue, 265 N.C. 165, 143 S.E.2d 113 (1965), this Court held that where a corporation realizes a gain from the liquidation of wholly owned

subsidiaries, that gain, even though not taxable income under N.C.G.S. §105-144(c), constitutes income "from all sources including income not taxable" under N.C.G.S. §105-147(9)(d)(2) which must be deducted from any loss carryover from a previous year. And in Dayco Corp. v. Clayton, Comr. of Revenue, 269 N.C. 490, 153 S.E.2d 28 (1967), this Court held that dividends received by a foreign corporation from its stock in nonsubsidiary corporations and capital gains received from the sale of stock in the same nonsubsidiary corporations must be deducted from the claimed carryover loss, because even though the income is derived from out of state transactions and is therefore not taxable by North Carolina, it nevertheless falls into the category of "income not taxable under this article" under N.C.G.S. §105-

147(9)(d)(2). Since "taxable income" means income on which North Carolina levies a tax pursuant to the Revenue Act, all other income is "income not taxable under this [Division]." Dayco Corp. v. Clayton, Comr. of Revenue, 269 N.C. at 498, 153 S.E.2d at 33. With respect to corporations, income "not taxable" under the North Carolina Revenue Act consists of income exempt from taxation and income allocated to other states which is therefore not taxable by North Carolina. Id. at 496, 153 S.E.2d at 32.

These cases, together with the rules of statutory construction referred to above, persuade us that the Secretary has correctly interpreted N.C.G.S. §105-147(9)(d)(2) in N.C. Admin. Code. tit. 17, r. 6B.2604. Nothing in the statute limits its application to resident individuals or to foreign corporations or

interstate businesses. Further, nothing in the language of this Court's prior cases in the area leads us to hold otherwise. We conclude, therefore, that with respect to nonresident individuals, income from sources outside North Carolina is the equivalent of corporate income allocated to other states and is "income not taxable under this Division," which must be included in arriving at an allowable carryover deduction in an ensuing year. N.C.G.S. §105-147(9)(d)(2) (1985); Dayco Corp. v. Clayton, Comr. of Revenue, 269 N.C. 490, 153 S.E.2d 28.

The Court of Appeals determined that the Secretary's interpretation of the carryover loss provision exceeded statutory authority as espoused in the statute's general purpose clause, which provides as follows:

> The general purpose of this Division is to impose a tax for the use of the State

> government upon the net income in excess of the exemptions herein allowed collectible annually:
>
> . . . .
>
> (2) Of every nonresident individual deriving income from North Carolina sources attributable to the ownership of any interest in real or tangible personal property in this State or deriving income from a business, trade, profession, or occupation carried on in this State.

N.C.G.S. §105-134 (1985). We disagree. A virtually identical general purpose section was in effect from 1939 through 1967, but the Secretary's interpretation of the loss carryover provision was never held to contravene it. Since we have concluded that N.C.G.S. §105-147(9)(d)(2) applies with equal force to a non-resident individual as it does to a foreign corporation or interstate business, the Secretary's interpretation of this subsection a fortiori does not

contravene the general purpose clause.

We hold that the Secretary's interpretation of N.C.G.S. §105-147(9)(d)(2), as evidenced by title 17, rule 6B.2604 of the North Carolina Administrative Code, does not exceed legislative authority.

In view of our disposition of this case, we do not address the other issues presented. Because we hold that the Secretary's interpretation of N.C.G.S. §105-147(9)(d)(2) does not violate either constitutional or legislative authority, the opinion of the Court of Appeals is necessarily reversed. The case is remanded to the Court of Appeals for remand to the Superior Court, Wake County, for further proceedings not inconsistent with this opinion.

REVERSED AND REMANDED.

No. 336PA87 - Aronov v. Secretary of Revenue

Justice Martin dissenting.

I respectfully dissent. Using the taxpayer's Alabama income to offset carry-over losses is in effect a taxation of that income by the state of North Carolina, in contravention of the taxpayer's constitutional rights.

The majority correctly identifies the two United States Supreme Court cases pertinent to the constitutional issue but goes astray in applying them to the facts of this case. In Maxwell v. Bugbee, 250 U.S. 525, 63 L. Ed. 1124 (1919), the taxpayer challenged on due process grounds an inheritance statute which set the tax rate for the transfer of in-state property by determining the ratio of that property to the decedent's entire estate, wherever situated. The Supreme Court

upheld the statute, holding that "property not in itself taxable by the State may be used as a measure of the tax imposed." Id. at 539, 63 L. Ed. at 1131.

Six years later, in Frick v. Pennsylvania, 268 U.S. 473, 69 L. Ed. 1058 (1925), the Court was confronted with an inheritance statute which included the value of the decedent's out-of-state property in calculating the value of the gross estate to be taxed. The Court struck down the statute as violative of the due process clause of the fourteenth amendment, noting that "'it is impossible for one State to reach out and tax property in another without violating the Constitution, for where the power of the one ends the authority of the other begins.'" Id. at 491, 69 L. Ed. at 1063 (quoting United States v. Bennett, 232 U.S. 299, 306, 58 L. Ed.

612, 616 (1914)).

The Frick Court distinguished Maxwell on the grounds that in Maxwell the inclusion of out-of-state property affected only the rate of the tax. This Court has itself recognized this distinction in Rigby v. Clayton, Comr. of Revenue, 274 N.C. 465, 164 S.E.2d 7 (1968). There we noted that "the 'Due process' provisions of the Federal or State Constitution are not violated by the use of value of the entire estate, wherever located, to determine the rate of the tax to be applied." Id. at 469, 164 S.E.2d at 10.

It is to be remembered that Maxwell, like Rigby, was not concerned with a tax on property, but with the determination of the tax rate to be applied upon the transmission of property from the dead to the living. The tax in Maxwell and Rigby

was a tax on the privilege to succeed to property. Rigby, 274 N.C. 465, 164 S.E.2d 7. In the case before us we are involved with determining the amount of income subject to the statutorily established tax rate. Likewise, in Frick the United States Supreme Court was concerned with determining the amount or value of the property to be taxed.

The majority also recognizes this distinction but inexplicably mischaracterizes the present case as more analogous to Maxwell than to Frick. It is clear to me that the state is not using the Alabama income to determine the rate at which the North Carolina income will be taxed. The rates for individual income tax, ranging from two percent to seven percent, have already been set by statute. See N.C.G.S. §105-136 (1985). Here the state seeks instead to use the

Alabama income to increase the amount or value of North Carolina income to be taxed by eliminating a legitimate loss deduction. This is a far cry from the situation in Maxwell, where the value of nontaxable out-of-state property solely affected the rate of tax while the value of in-state property to be taxed remained the same. Let us reverse the facts. Could the taxpayer use his Alabama losses to reduce his taxable North Carolina income? Obviously, the answer is no. Likewise, the state cannot use Aronov's Alabama gains to increase the amount of his taxable North Carolina income.

All parties agree that Alabama income is not taxable in North Carolina. A state may not tax value earned outside its borders. ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 73 L.Ed. 2d 787 (1982). Yet, under the majority's

view, the taxpayer's liability is the same as it would have been had his Alabama income in 1975, 1976, and 1977 been North Carolina income. The majority's opinion is thus "the equivalent of saying that it was admissible to measure the tax by a standard which took no account of the distinction between what the State had power to tax and what it had no power to tax, and which necessarily operated to make the amount of the tax just what it would have been had the State's power included what was excluded by the Constitution." Frick at 494-95, 69 L. Ed. at 1064 (emphasis added). Such an approach is untenable because, as in Frick, "[i]t would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of

no avail." Id. at 495, 69 L. Ed. 2d at 1064-65. An attempted taxation must fail "where the State exceeds its authority in imposing a tax upon a subject-matter within its jurisdiction in such a way as to really amount to taxing that which is beyond its authority." Maxwell at 539-40, 63 L. Ed. at 1131 (emphasis added).

The majority opinion now relies upon both Frick and Maxwell. In accord with Maxwell it states that "the taxpayer's Alabama income has not been used to determine whether he had income subject to taxation in North Carolina," arguing that the Alabama income was only used to determine the rate or increase of the tax to be applied. Later, the majority holds: "Here the taxpayer's Alabama income is merely used to determine the amount of his properly taxable North Carolina income..." Thus the majority first holds

that the Alabama income was only used to determine the rate of the tax, but finally admits that it was used to determine the amount of income to be subject to taxation under the statutory rate schedule.

By allowing the Alabama income to be used to determine the amount of the taxpayer's taxable income, the majority opinion violates the constitutional mandates of Frick. The majority engages in the utmost sophistry in upholding a tax premised solely upon the existence of constitutionally protected out-of-state income.

Although deductions are a privilege, where the state allows them it must apply them in a constitutional manner. It cannot arbitrarily remove them as to individual taxpayers without running afoul of constitutional due process

guarantees. The majority opinion is constitutionally flawed. "The power of taxation shall be exercised in a just and equitable manner..." N.C. Const. Art. V. §2(1). I agree with the reasoning in Judge Becton's well-drawn opinion below and vote to affirm the Court of Appeals.

APPENDIX B

No. 336PA87 TENTH DISTRICT

SUPREME COURT OF NORTH CAROLINA

* * * * * * * * * * * * * * * * * *

AARON ARONOV	)	
	)	From Wake
v	)	
	)	(8610SC971)
SECRETARY OF REVENUE, DEPARTMENT OF REVENUE, STATE OF NORTH CAROLINA	)	

* * * * * * * * * * * * * * * * * *

ORDER

Upon consideration of the petition filed by Plaintiff in this matter for rehearing of the decision of this Court pursuant to Rule 31, N. C. Rules of Appellate Procedure, the following order was entered and is hereby certified to the North Carolina Court of Appeals:

> "Denied by order of the Court in conference, this the 3rd day of November, 1988.
>
> s/Whichard, J.
> For the Court"

WITNESS my hand and the seal of the Supreme Court of North Carolina, this the 7th day of November, 1988.

J. GREGORY WALLACE
Clerk of the
Supreme Court

/s/ Peggy M. Byrd
Assistant Clerk

APPENDIX C

NO. 8610SC971

NORTH CAROLINA COURT OF APPEALS

Filed: 19 May 1987

AARON ARONOV

v. Wake County
No. 85CVS2214

SECRETARY OF REVENUE,
DEPARTMENT OF REVENUE,
STATE OF NORTH CAROLINA.

Appeal by Secretary of Revenue from Bailey, Judge. Order entered 29 May 1986 in Superior Court, Wake County. Heard in the Court of Appeals 2 March 1987.

Attorney General Lacy H. Thornburg, by Assistant Attorney General Newton G. Pritchett, Jr., for the Secretary of Revenue, Department of Revenue, State of North Carolina.

Kenneth G. Anderson, by Kenneth G. Anderson and James P. Stevens; and Hunter, Wharton & Howell, by John V. Hunter, III, for petitioner appellee.

BECTON, Judge.

Taxpayer, Aaron Aronov, filed a protest to his 1978 income tax assessment of $17,839.09. The assessment was sustained in a hearing before the Assistant Secretary of Revenue. Aronov appealed to the Tax Review Board, and the Board affirmed the Assistant Secretary's decision. Aronov paid a bond in the amount of the taxes and then petitioned for review in Wake County Superior Court where the Secretary of Revenue became a party. The trial court reversed the Tax Review Board's decision. The Secretary now appeals to this Court. We affirm.

I

Aaron Aronov, a resident of Alabama, was one of three partners in an unsuccessful business venture in North Carolina. The partnership's chief asset

in this State was a shopping center known as "Freedom Mall." During its three years of operation the cumulative partnership losses from the operation of the shopping center were $983,901.61. The property was sold in lieu of foreclosure in 1978 for $100.00 plus the outstanding mortgage. After interest and other expenses totaling $28,590.70, the partnership reported $955,507.50 as gain in 1978. Aronov calculated his 1978 North Carolina income taxes as follows. He reported one-third of $955,507.50, or $257,987.03 as his distributive share of the gain from the sale of the shopping center. He deducted from this income a carryover loss of $257,987.03, his cumulative distributive share of the distributive share of the partnership's net operating losses for 1975, 1976 and 1977. By offsetting the gain from the

sale of the shopping center with the losses carried forward for those three years. Aronov reflected no North Carolina net income on his personal North Carolina tax return for 1978.

During the three years for which Aronov carried over his losses, he derived substantial income from sources outside North Carolina. None of that income was subject to North Carolina taxes.

The Secretary, however, applied Aronov's Alabama net income to the years 1975-1977 and determined that Aronov could not carry forward his losses from those years because, when considering his other income, he did not have net losses for any of those years. The Secretary concluded that Aronov had income of $257,987.03 in 1978, subject to taxes of $17,839.09. This assessment was

sustained by the Assistant Secretary and the Tax Review Board.

The trial court reversed the Board's decision, finding that the decision of the Board and the Assistant Secretary result in the income taxation by the State of North Carolina of income earned by Aronov in other states and which had no connection with this State in violation of the due process clause of the Fourteenth Amendment to the United States Constitution, the commerce clause of the United States Constitution, and the Law of the Land Clause of the North Carolina constitution. Additionally, the trial court found that the Assistant Secretary's interpretation exceeded statutory authority and was arbitrary and capricious.

II

The Secretary's sole argument on appeal is that the trial court erred in reversing the Board because its conclusions of law were not supported by the evidence. Essentially, the Secretary contends that the trial court had no basis in law or fact for its finding that the Secretary's interpretation of N.C. Gen. Stat. Sections 105-147(9)d 2 and 3 (1985) resulted in the unlawful taxation of Aronov's Alabama income. We disagree.

A

N.C. Gen. Stat. Sections 105-147(9)d 2 and 3 provide in pertinent part that business "losses in the nature of net economic losses sustained in any or all of the five preceding income years..." may be carried forward. But "[t]he net economic loss for any year shall mean the amount by which allowable deductions for

the year... and prior year losses shall exceed income from all sources in the year including any income not taxable under this Division" and "[a]ny net economic loss of a prior year or years brought forward and claimed as a deduction in any income year may be deducted from taxable income of the year only to the extent that such carry-over loss from the prior year or years shall exceed any income not taxable under this Division received in the same year in which the deduction is claimed..." (emphasis added). The Secretary maintains that the above language precludes Aronov from carrying forward his losses during 1975-1977 because his "income from all sources in [those years] including any income not taxable under [that] Division" exceeded his North Carolina losses. The income "from all

sources" which prevented Aronov from having net losses in those years was income earned in Alabama.

North Carolina does not have the power to tax income of a nonresident earned outside North Carolina and which has no connection with this State. See Frick v. Pennsylvania, 268 U.S. 473, 69 L.Ed. 1058 (1925). Any attempt to do so offends the due process clause of the Fourteenth Amendment to the United States Constitution. Id. at 488-89, 69 L.Ed. at 1062. The Secretary argues, however, that her interpretation of Sections 105-147(9) d 2 & 3 does not result in taxation of non-North Carolina income, and that Aronov's income from other sources is used only to limit his entitlement to a deduction. She contends that "deductions are in the nature of exemptions; they are privileges, not

matters of right, and are allowed as a matter of legislative grace," citing Ward v. Clayton, 5 N.C. App. 53, 167 S.E.2d 808 (1969), affirmed, 276 N.C. 411, 172 S.E.2d 531 (1970). The court is mindful of this and the other long-standing legal postulates regarding statutory interpretation to which the Secretary made reference including the following: A taxpayer claiming a deduction must bring himself within the statutory provisions authorizing the deductions. 85 C.J.S., Taxation Sec. 1099, at 772 (1954). A statute providing exemption from taxation is strictly construed against the taxpayer and in favor of the State. See Food House, Inc. v. Coble, 289 N.C. 123, 221 S.E.2d 297 (1976). Indeed, "the underlying premise when courts interpret taxing statutes is: 'Taxation is the rule; exemption is the

exception' [citation omitted]." Broadwell Realty Corp. v. Coble, 291 N.C. 608, 611, 231 S.E.2d 656, 658 (1977). And in all tax cases, the construction placed upon the statute by the Commissioner (now Secretary) of Revenue, although not binding, will be given due consideration by a reviewing court. See Campbell v. Currie, 251 N.C. 329, 111 S.E.2d 319 (1959). Notwithstanding the above guidelines, if the Secretary's interpretation of G.S. Sections 105-147(9)d2 and 3 has the effect of taxing Aronov's Alabama income, it exceeds both statutory and constitutional authority and cannot stand.

B

Additionally, the Secretary contends that we are bound by the North Carolina Supreme Court's holding in Dayton Rubber Co. v. Shaw, 244 N.C. 170, 92 S.E.2d 799

(1956) in which the court upheld the Commissioner's interpretation of N.C. Gen. Stat. Sec. 105-147(6) (the predecessor to section 105-147(9)d 2). In Dayton Rubber the Supreme Court upheld the Commissioner's reduction of the foreign corporate taxpayer's carryover losses by applying royalty payments from out of state that were not connected with its North Carolina operations. However, contrary to the Secretary's assertion, the court did not address the question whether, by limiting the deduction, the Commissioner was in effect taxing non-North Carolina income. Indeed in a later case, Dayco Corporation v. Clayton, 269 N.C. 490, 153 S.E.2d 28 (1967), the Supreme Court specifically left that question open, stating at the outset that "[t]he plaintiff does not contend that the assessment in question has the effect

of the levy of a tax on income which is beyond the constitutional power of the State to tax." Id. at 494, 153 S.E.2d at 30-31. Thus we must decide whether the use of non-North Carolina income to reduce the nonresident taxpayer's carryover losses is an indirect attempt to tax income not taxable by this State.

C

A number of United States Supreme Court and federal court cases have addressed the question of indirect taxation under analogous tax schemes. For example, the United States Supreme Court upheld a New Jersey tax statute that permitted the State to subject a nonresident decedent's estate to an inheritance tax at a rate which had the same ratio to the entire tax as the New Jersey property had to the entire estate. Maxwell v. Bugbee, 250 U.S. 525, 63 L.Ed.

1124 (1919). However, six years later in Frick v. Pennsylvania, 268 U.S. 473 (1925), the Court struck down a Pennsylvania tax statute that permitted the State to set the inheritance tax rate for the portion of the decedent's estate that was in Pennsylvania based on the entire estate, which included property outside Pennsylvania. The Court reasoned that the plaintiff's tax liability was the same as if the state had taxed that which it did not have the power to tax.

The United States Court of Appeals for the Tenth Circuit upheld a Kansas statute which permitted the State to combine a nonresident service member's military income with his Kansas income to set the rate at which the Kansas income was to be taxed. U.S. v. Kansas, 810 F.2d 935 (10th Cir. 1987). The court, applying the rationale of the Supreme

Court in Maxwell v. Bugbee, stated that "the inclusion in a state taxing scheme of property not subject to direct taxation by the state, for the purpose of determining the rate of taxation to be applied to property that is subject to the state's taxing powers, does not violate the due process clause of the Fourteenth Amendment. [citations omitted]."

The taxing schemes are varied and the results are difficult to reconcile. Some courts, like the Tenth Circuit in United States v. Kansas, have adapted the rationale of Maxwell v. Bugbee to various tax schemes which use out of state property to set the rate of taxation. See Wheeler v. State, 127 Vt. 361, 249 A.2d 887, appeal dismissed, 396 U.S. 4, 24 L.Ed.2d 4 (1969); McCutchan v. Oklahoma Tax Commission, 191 Okla. 578,

132 P.2d 337 (1942). In the case sub judice, however, the rate of taxation does not vary. Instead, Aronov's Alabama income is used to determine whether he even has income subject to taxation in North Carolina. Thus, we are more persuaded by the Supreme Court's reasoning in Frick. There the effect of the State's taxing scheme is the primary concern.

When the effect of the statute is to make the taxpayer's tax liability the same as it would have been had the state included income it did not have the power to tax, then the scheme must fall. In the case at bar, Aronov would have no North Carolina tax liability in 1978 were it not for the fact that he had net income in Alabama during 1975, 1976 and 1977. Consequently, under the Secretary's interpretation of Sections

105-147(9)d2 and 3, his 1978 tax liability is what it would have been had his Alabama gains during the three preceding years been North Carolina gains. The result is a sophisticated scheme which taxes belatedly, the nonresident taxpayer's non-North Carolina income. The Secretary's interpretation of sections 105-147(9)d 2 and 3 therefore violates the due process clause of the Fourteenth Amendment and the Law of the Land Clause of the North Carolina Constitution.

III

Additionally, the Secretary's imposition of an indirect tax on the nonresident taxpayer's Alabama income contravenes legislative intent to tax only the North Carolina income of nonresident taxpayers. The legislature's

intent is specifically outlined in the "Purpose" section of Division II which provides:

> The general purpose of this Division is to impose a tax for the use of the State government upon the net income in excess of the exemptions herein allowed collectible annually:
>
> . . .
>
> (2) Of every nonresident individual deriving income from North Carolina sources attributable to the ownership of any interest in real or tangible personal property in this State or deriving income from a business, trade, profession or occupation carried on in this State. [Citation omitted.]

N.C. Gen. Stat. Sec. 105-134 (1985). This Court will not follow an administrative interpretation which is in direct conflict with the clear intent and purpose of the statute under consideration. See Watson Industries v. Shaw, 235 N.C. 203, 69 S.E.2d 505 (1952).

IV

We hold that the Secretary's interpretation of Sections 105-147(9)d 2 and 3 results in the indirect taxation of Aronov's Alabama income in violation of the due process clause of the Fourteenth Amendment of the United States Constitution and North Carolina's Law of the Land Clause and exceeds statutory authority as espoused in the statute's general purpose clause. We need not reach the question whether the Secretary's interpretation violates the commerce clause of the United States Constitution.

Judgement is affirmed.

Chief Judge HEDRICK and Judge WELLS concur.

APPENDIX D

NORTH CAROLINA — IN THE GENERAL COURT OF JUSTICE
WAKE COUNTY — SUPERIOR COURT DIVISION

85 CvS 2214

AARON ARONOV,

Plaintiff

v. ORDER

SECRETARY OF REVENUE,
DEPARTMENT OF REVENUE,
STATE OF NORTH CAROLINA,

Defendants

THIS MATTER coming on to be heard, and being heard before the undersigned, Judge holding the May 27, 1986, Civil Non-jury Session of Wake County Superior Court, for judicial review pursuant to G.S. §150A-43 and §105-241.3 of Administrative Decision No. 212 of the Tax Review Board of the State of North Carolina entered January 31, 1985, in the matter of the Petition of Aaron Aronov

with respect to the decision of the Assistant Secretary of Revenue with respect to the proposed assessment of income tax as to Mr. Aronov for the taxable year 1978;

And the court having taken no additional evidence, and having heard the matter upon the administrative record, the argument of counsel, and the briefs submitted by counsel, the Court concludes:

1. The decision of the Tax Review Board and of the Assistant Secretary of Revenue, and the regulation (Title 17, North Carolina Administrative Code, Subchapter 6B, Rule .2604, April 6, 1984), result in the income taxation by the State of North Carolina of income earned by the taxpayer, a nonresident of North Carolina, in other states, and

having no connection whatever with the state of North Carolina, and violates the due process clause (Amendment XIV, Section 1) of the Constitution of the United States, the commerce clause (Article I, Section 8, Cl. 3) of the Constitution of the United States, and the law of the land clause (Article I, Section 19) of the Constitution of the State of North Carolina) (sic).

2. The decision of the Tax Review Board and the Assistant Secretary of Revenue exceeds statutory authority and is legally erroneous, because G.S. §105-141(b) and §105-147(9)d 2 and 3 do not support the Assistant Secretary's interpretation of the statutes, which interpretation results in the taxation of non-North Carolina income of the nonresident taxpayer.

3. The interpretation of the pertinent statutes by the Secretary of Revenue appearing in the regulations above cited constitutes an attempt to tax the income of a nonresident taxpayer derived from activities in another state having no connection with the State of North Carolina, and is invalid because it is in violation of the due process clause (Amendment XIV, Section 1) of the Constitution of the United States, the commerce clause (Article 1, Section 8, Cl. 3) of the Constitution of the United States, and the law of the land clause (Article 1, Section 19) of the Constitution of the State of North Carolina.

4. The decision of the Tax Review Board and the Assistant Secretary of Revenue is arbitrary and capricious.

NOW, THEREFORE, it is hereby ORDERED, ADJUDGED and DECREED:

1. Final Administrative Decision No. 212 of the Tax Review Board of the State of North Carolina entered January 31, 1985, with respect to the Taxpayer Aaron Aronov is reversed.

2. The assessment of income tax against the taxpayer in the amount of $17,839.09, with interest, as additional income tax for the taxable year 1978, is reversed, and the taxpayer Aaron Aronov is not obligated to pay the same.

3. The costs of this proceeding are taxed against the State of North Carolina.

This 29 day of May, 1986.

/s/ James H. Pou Bailey
James H. Pou Bailey
Judge Presiding

APPENDIX E

STATE OF NORTH CAROLINA

BEFORE THE

TAX REVIEW BOARD

In the Matter of the Petition of Aaron Aaronov for an Administrative Review of the Decision of the Assistant Secretary of Revenue with Respect to the Proposed Assessment of Income Tax for the Taxable Year 1978.	)))))))	ADMINISTRATIVE DECISION NO. 212 Entered January 31, 1985

On September 19, 1984, Aaron Aronov (petitioner), by and through counsel, filed with the Tax Review Board (Board) his petition for review of the decision of the Assistant Secretary for Revenue entered on June 21, 1984, in which assessments of additional income tax and interest were sustained.

On January 31, 1985, a meeting of the Tax Review Board was held in the City of Raleigh with the following members present: Harlan E. Boyles, State

Treasurer, Chairman; Robert K. Koger, Chairman, Utilities Commission; and T. N. Brafford. Also present was B. E. Dail, Secretary to the Board. The Assistant Secretary for Revenue was represented by counsel, Newton G. Pritchett, Jr., Assistant Attorney General, and by B. W. Brown, Director, Individual Income Tax Division. The petitioner was represented by counsel, Barbara Pattillo.

Having heard the arguments of counsel for the petitioner and respondent, and having considered the record, the Board made the following:

FINDINGS OF FACT

The Board adopts as its findings of fact the facts found by the Assistant Secretary for Revenue.

Based thereon, the Board made the following:

CONCLUSIONS OF LAW

The Board adopts as its conclusions of law the conclusions of law made by the Assistant Secretary for Revenue. The Board further concludes that it is an administrative body of the executive branch of government and, as such, has no authority to pass upon the constitutionality of statutes.

THEREFORE, IT IS ORDERED that the decision of the Assistant Secretary for Revenue be affirmed in all respects. The petition is dismissed.

This 31st day of January, 1985.

TAX REVIEW BOARD

/s/ Harlan E. Boyles
Harlan E. Boyles, Chairman
State Treasurer

/s/ Robert K. Koger
Robert K. Koger, Chairman
Utilities Commission

/s/ T. N. Brafford
T. N. Brafford

CERTIFICATE OF SERVICE

The undersigned hereby certifies that he has this day served a copy of the foregoing Administrative Decision upon the persons named below by mailing to the last known address of said persons a written copy of said decision, by registered mail, postage and fees prepaid:

Aaron Aronov
2088 Myrtlewood Drive
Montgomery, Alabama 36111

Barbara T. Pattillo
Law Offices of Kenneth G. Anderson
Suite 2540 - Gulf Life Tower
Jacksonville, Florida 32207

This the 1st day of March, 1985.

/s/ B. E. Dail
B. E. Dail
Secretary to the Tax
Review Board

APPENDIX F

STATE OF NORTH CAROLINA WAKE COUNTY		BEFORE THE SECRETARY OF NORTH CAROLINA
In the Matter of The Proposed Assessment of Income Tax for the Taxable Year 1978 by the Secretary of Revenue of North Carolina, vs. AARON ARONOV, Taxpayer	)	FINAL DECISION

This matter was heard before the Assistant Secretary for Revenue of North Carolina, in the City of Raleigh, on May 14, 1984, upon an application for hearing filed by the taxpayer, Aaron Aronov, wherein he protested the proposed assessment of income and interest for the taxable year 1978.

Those persons in attendance at the hearing before the Assistant Secretary for Revenue were Kenneth G. Anderson, attorney for the taxpayer; B. W. Brown,

Director of the Individual Income Tax Division; C. Roland Young, Tax Auditor from the Audit Section of the Individual Income Tax Division; and Newton G. Pritchett, Associate Attorney General.

The taxpayer's North Carolina individual income tax return for the taxable year 1978 was timely filed. The return reflected income of $257,987, representing the taxpayer's distributive share of the income of Freedom Drive Mall, Ltd., a limited partnership. Against this income the taxpayer claimed a net economic loss of $257,987, which represented his distributive shares of the operating losses of Freedom Drive Mall, Ltd., for the taxable years 1975, 1976 and 1977. Pursuant to the provisions of G. S. 105-241.1, a Notice of Income Tax Adjustment for the taxable year 1978 was mailed to the taxpayer on

May 21, 1980, disallowing the net economic loss of $257,987.

The taxpayer filed a timely protest to the proposed assessment and requested a hearing before the Secretary of Revenue.

This case was originally heard by the Secretary of Revenue on May 12, 1981, upon the taxpayer's contentions that he realized no income subject to North Carolina income tax in 1978 and that the State was seeking to unconstitutionally impose its income tax on nonresident income. The Secretary's decision sustaining the assessment in its entirety was entered on August 4, 1981. The taxpayer, through his attorney, Mr. Kenneth G. Anderson, appealed the Secretary's Decision to the Tax Review Board, contending that evidence of the fair market value of certain partnership

property from which the taxpayer derived the income on which the tax was imposed was necessary to determine his liability for the tax, but such evidence was not in the record. Because of that, the Secretary of Revenue, with the concurrence of the taxpayer, filed a motion with the Tax Review Board to remand the case to him for rehearing. The case was subsequently remanded to the Secretary on April 7, 1982.

Since the prior hearing, the United States Supreme Court has held that when a taxpayer sells or disposes of property encumbered by a nonrecourse obligation exceeding the fair market value of the property, the full amount of the obligation assumed by the purchaser must be included in the amount realized from the sale and that the fair market value of the property is irrelevant to the

calculations. (Commissioner of Internal Revenue v. John F. Tufts, et al. 83-1 USTC 9328)

This being the case, Mr. Anderson stated that the taxpayer would forego the prior contentions that evidence of the fair market value of the property was necessary to determine his taxable gain and the matter to be dealt with at this hearing would be the other issue raised at the first hearing.

ISSUE

The issue to be decided in this matter is:

Must the net economic loss claimed by the taxpayer be reduced by the amount of income received from sources outside North Carolina in determining the amount of the loss to be carried over and claimed as a deduction in 1978?

APPLICABLE LAW AND LEGAL AUTHORITY

The applicable law and legal authority in effect during the taxable year 1978 with respect to the taxpayer's income tax liability were:

G.S. 105-136

G.S. 105-140

G.S. 105-141(a)

G.S. 105-142(c)

G.S. 105-147(9)d

G.S. 105-241.1

EVIDENCE

The evidence presented at the first hearing before the Secretary of Revenue which is also included as evidence at this hearing consisted of the following:

(1) Taxpayer's North Carolina individual income tax return for the taxable year 1978, a copy of which is

designated as Secretary's Exhibit 1.

(2) Notice of Income Tax Adjustment for the taxable year 1978 dated May 21, 1980, a copy of which is designated as Secretary's Exhibit 2.

(3) Tax Information Authorization signed by the taxpayer on July 17, 1980, a copy of which is designated as Secretary's Exhibit 3.

(4) Letter from Kenneth G. Anderson, Attorney for the taxpayer, to P. B. Pearson dated June 13, 1980, a copy of which is designated as Secretary's Exhibit 4.

(5) Letter from Kenneth G. Anderson, Peter W. Mettler and Byrd C. Fryer, Attorneys for the taxpayer, to P. B. Pearson dated July 16, 1980, a copy of which is designated as Secretary's Exhibit 5.

(6) Letter from F. Russ Neely,

Administrative Officer of the Individual Income Tax Division, to Kenneth G. Anderson dated February 16, 1981, a copy of which is designated as Secretary's Exhibit 6.

(7) Letter from Kenneth G. Anderson to the Department of Revenue dated March 5, 1981, a copy of which is designated as Secretary's Exhibit 7.

(8) Letter from B. W. Brown, Director of the Individual Income Tax Division, to Kenneth G. Anderson dated April 2, 1981, a copy of which is designated as Secretary's Exhibit 8.

(9) Letter from Kenneth G. Anderson to B. W. Brown dated April 7, 1981, a copy of which is designated as Secretary's Exhibit 9.

(10) Letter from Kenneth G. Anderson to the Department of Revenue dated May 11, 1981, presented by Mr.

Anderson at the hearing, a copy of which is designated as Secretary's Exhibit 10.

(11) A copy of the conveyance of leasehold estate and bill of sale between Freedom Drive Mall, Ltd. and Freedom Mall Associates dated March 1, 1978, a copy of which is designated as Secretary's Exhibit 11.

(12) A copy of an affidavit of David R. Stambaugh, general partner of Freedom Drive Mall, Ltd. dated March 1, 1978, a copy of which is designated as Secretary's Exhibit 12.

(13) A copy of the assignment of subleases and of security between Freedom Drive Mall, Ltd. and Freedom Mall Associates dated March 1, 1978, a copy of which is designated as Secretary's Exhibit 13.

(14) Copies of the promissory note and deed of trust between Freedom Drive

Mall, Ltd. and First Chicago Realty Services Corporation dated July 16, 1975, copies of which are designated as Secretary's Exhibits 14 and 15, respectively.

(15) The North Carolina partnership income tax returns of Freedom Drive Mall, Ltd. for the taxable years 1975, 1976, 1977 and 1978, copies of which are designated as Secretary's Exhibits 16, 17, 18 and 19, respectively.

At this hearing, Mr. Anderson submitted a document titled "Supplemental Memorandum in Support of Taxpayer's Position Regarding Constitutional Imposition of Tax on Nonresident Income", a copy of which is designated as Secretary's Exhibit 20.

FINDINGS OF FACT

Based upon the foregoing evidence of

record, the Assistant Secretary for Revenue makes the following findings of fact:

(1) The taxpayer is a nonresident of North Carolina and was a nonresident at all times material to this hearing, including the taxable year 1978.

(2) The taxpayer filed a timely North Carolina individual income tax return for the taxable year 1978 reflecting no tax due.

(3) During the taxable years 1975, 1976, 1977 and 1978 the taxpayer was a partner in Freedom Drive Mall, Ltd., a limited partnership operating a shopping center in Charlotte, North Carolina.

(4) During the taxable years 1975, 1976, and 1977, Freedom Drive Mall, Ltd. realized net operating losses of $195,438.62, $309,789.78 and $450,279.10, respectively.

(5) The taxpayer distributive share of the net operating losses of Freedom Drive Mall, Ltd. for the taxable years 1975, 1976 and 1977 were $52,768.43, $83,643.24 and $121,575.36, respectively.

(6) On March 1, 1978, Freedom Drive Mall, Ltd. sold its interest in the shopping center to Freedom Mall Associates, Inc., a Delaware corporation, for $100.00 and cancellation of its indebtedness to First Chicago Realty Corporation, said indebtedness having been secured by a deed of trust on the shopping center.

(7) Freedom Drive Mall, Ltd. reported the sale of the shopping center on its 1978 partnership income tax return in the following manner:

Gross sales price		$,6,992,807.63
Cost or other basis	$6,731,963.86	
Less depreciation	723,057.84	
Adjusted cost basis		6,008,906.02
Gain		$ 983,901.61

(8) During the taxable year 1978, Freedom Drive Mall, Ltd. realized total income of $984,098.20, which included the gain from the sale of the shopping center. After deducting interest and other expenses of $28,590.80, the partnership realized net income of $955,507.50.

(9) The taxpayer's distributive share of the net income of Freedom Drive Mall, Ltd. for the taxable year 1978 was $257,987.03.

(10) During the taxable years 1975 1976 and 1977, the taxpayer's income from sources outside North Carolina was $118,056.00, $283,758.00 and $488,908.00, respectively.

(11) On his individual income tax return for the taxable year 1978 the taxpayer reported $257,987.00 as his distributive share of the net income of Freedom Drive Mall, Ltd. for 1978. As a

deduction from this income, the taxpayer claimed a carryover loss of $257, 987.00, which represented his accumulated distributive shares of the net operating losses of Freedom Drive mall, Ltd. for the taxable years 1975, 1976 and 1977.

(12) On May 21, 1980, a Notice of Income Tax Adjustment was mailed to the taxpayer disallowing the carryover loss of $257,987 claimed on his individual income tax return for the taxable year 1978.

(13) The taxpayer filed a timely protest to the assessment and requested a hearing before the Secretary of Revenue.

CONCLUSIONS OF LAW

(1) With respect to an individual who is not a resident of North Carolina, G. S. 105-136 imposes a tax "...upon the net income derived from North Carolina

sources of every nonresident individual which is attributable to the ownership of any interest in real or tangible personal property in this State or which is from a business, trade, profession, or occupation carried on in this State...".

(2) G. S. 105-140 defines "net income" as the gross income of a taxpayer less the deductions allowed by law.

(3) G. S. 105-141(a) defines gross income as all income in whatever form and from whatever source derived, including gains derived from dealings in property, income from discharge of indebtedness and the distributive share of partnership income, subject to the provisions of G. S. 105-142(c).

(4) G. S. 105-142(c) requires an individual carrying on a business in partnership to include in his gross income, whether distributed or not, his

distributive share of the net income of the partnership for each income year.

(5) G. S. 105-147(9)d allows a taxpayer to deduct, subject to certain limitations, "Losses in the nature of net economic losses sustained in any or all of the five preceding income years arising from business transactions or to capital or property...". The statute further provides that "The purpose in allowing the deduction of net economic loss of a prior year or years is that of granting some measure of relief to taxpayers who have incurred economic misfortune or who are otherwise materially affected by strict adherence to the annual accounting rule in the determination of taxable income, and the deduction herein specified does not authorize the carrying forward of any particular items or category of loss

except to the extent that such loss or losses shall result in the impairment of the net economic situation of the taxpayer such as to result in a net economic loss as hereinafter defined".

(6) G. S. 105-147(9)d.2 defines a net economic loss as "...the amount by which allowable deductions for the year other than personal exemptions, nonbusiness deductions and prior year losses shall exceed income <u>from all sources in the year</u> including any income not taxable under this Division". Emphasis added.

(7) The Notice of Income Tax Adjustment was issued pursuant to the requirements of G. S. 105-241.1

(8) The tax assessment against the taxpayer is, under the facts, lawful and proper.

DECISION

The constitutionality of a statute is not a matter to be considered by the Secretary of Revenue in an administrative hearing.

The Assistant Secretary for Revenue concurs with the decision in the first case that in determining the amount of a net economic loss for any year, the statute clearly requires the taxpayer to reduce such loss by all of his income for the year, both taxable and nontaxable, including any income not subject to North Carolina income tax by virtue of the income having been received from sources outside North Carolina; and that in consequence thereof, the taxpayer did not sustain a net economic loss in 1975, 1976 or 1977 because his income from sources outside North Carolina during each of those years exceeded his distributive

shares of the net operating losses of Freedom Drive Mall, Ltd.

THEREFORE, the tax assessed against the taxpayer for the taxable year 1978 is proper under the law and the facts, is correct in amount, and is hereby sustained in its entirety.

Made and entered this 21st day of June, 1984.

/s/ Keith Goodson
Assistant Secretary
for Revenue